C.D. Howe Institute
Commentary

91-04203/

C.D. Howe Institute

No. 30, May 1991 ISSN 0824-8001

Soviet Economy

Soviet Economic Reforms:

Lost Opportunities and Remaining Hopes

by

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The history of Soviet economic *perestroika* seems to be one of lost opportunities. A viable plan to smooth the transition to a market economy was proposed, but it was not implemented. Now, real incomes of Soviet citizens have fallen and will continue to do so as the Soviet Union's economy heads into deep recession in 1991.

Yet despite evident mismanagement, the Soviet economy is drifting slowly toward a market-based system. All major political forces, including Communist hardliners, now support the idea of the market, and the point of no-return to a command economy appears to have been passed.

The crucial problem now is how to minimize the costs of transition. As the economic slump continues and as real incomes fall, strikes, ethnic and social conflicts, and violence plague the Soviet Union — hardly a desirable environment for the emergence of democratic institutions in that country.

To prevent increasing chaos from leading to a more authoritarian regime, and to protect the fragile process of democratization, it might make sense for Western countries and international economic organizations to consider the idea of putting together a *perestroika* assistance package.

With or without Western assistance, however, life in the Soviet Union will go on, and so will *perestroika*. Things were even worse at times in the past, so what is needed now is patience on the part of the Soviet people and the willingness to work to bring about the transition to a full-fledged market economy.

Introduction

Economic reforms now unfolding in the Union of Soviet Socialist Republics are causing much debate all over the world, including in the USSR itself. *Glasnost* brought to the surface a tremendous variety of opinions that had earlier been suppressed, and the country now faces an extreme diversity of proposals for economic programs, ranging from those of the far left to those of the far right (see Box 1).

Today, the government and the leadership of the Communist Party seem to occupy the central place in this debate, having moved gradually to the right in recent months. But many observers consider the situation unstable and warn that the delicate political balance may easily change.

How will government economic policy change in the near future? What are the factors that will influence this change? What is the optimal scenario for economic restructuring — that is, how can the country best assure a low-cost transition from an administrative command economy, such as it has now, to a market economy? Is this optimal scenario politically feasible? What will happen if this scenario fails to materialize? How can the West influence the *perestroika* process in the Soviet Union? Answers to all these questions are of crucial importance in evaluating the possible scenarios for economic *perestroika*.

The purpose of this *Commentary* is to analyze briefly the recent Soviet experience with economic restructuring, to outline the major options that economic reformers in the Soviet Union now face, to evaluate the political feasibility of these options, and to speculate on possible scenarios of future economic development and on the much-debated issue of Western financial assistance.

Box 1: *"Left" and "Right" in Today's Soviet Union*

The notions "left" and "right" are used in a peculiar way in the Soviet Union these days. The "leftists" are the strongest advocates of *perestroika*, a market-oriented economy, democratic institutions, and so on. The "rightists" are those who are against marketization, privatization, and depolitization of the army and the KGB. In brief, the leftists are the radicals, the advocates of change, while the rightists are the conservatives, trying to stop, or at least to slow down, the reforms. For example, Boris Yeltsin, chairman of Russia's Supreme Soviet, Gavriil Popov, chairman of the city of Moscow's Soviet, and Anatoliy Sobchak, chairman of the city of Leningrad's Soviet, are considered the leftists' leaders, while Yegor Ligachev, former Communist Party secretary in change of agriculture, and Ivan Polozkov, first secretary of Russia's Communist Party, are regarded as rightists.

Did the USSR Miss a Chance?

It is easy to be wise after the fact. The Soviet Union's many current shortages do not include a lack of comment on what the leadership should have done in the first years of *perestroika*. Yet, to be fair, in 1987 and 1988 some economists suggested a package of measures that, had they been implemented then, would probably have left the Soviet economy much better off than it is today. This program for national economic revival, which greatly resembled the plan Stanislav Shatalin put forward in September 1990, offered a chance to proceed with economic restructuring at a low cost, without considerable reduction of living standards.

The whole plan was based on the fact that the economic heritage of the era of Leonid Brezhnev was not all that bad. Indeed, in comparison with today's economic situation, it looks really impressive. The government budget deficit was considerably lower than it has been in recent years: less than 40 billion rubles in 1985, compared with about 100 billion in 1990. Net hard currency indebtedness was US$16 billion in 1985, but US$43 billion in 1991. The consumer market was much closer to equilibrium. Consumer prices were rising more slowly than they are today. Delayed consumer demand — calculated as the difference between the growth of personal disposable income and the growth of retail sales of consumer goods and services — was about

60 billion rubles or less than 20 percent of retail sales in 1984, but 165 billion rubles or 40 percent of sales in 1989.

Using this relatively favorable heritage, it would have been possible in 1988 to make a transition to an efficient market economy quickly and painlessly, provided that three major sets of reforms had been implemented decisively and simultaneously starting in 1987.

Centralized Planning Had to Go

The old administrative system of centralized planning had to be destroyed to create room for the operation of market forces. The idea was to reduce obligatory state orders for enterprises drastically — to cut mandatory production quotas to less than 50 percent of productive capacity — and eventually to place these state orders on a voluntary, competitive basis; to replace the system of rationed supply with wholesale trade; and to deregulate prices, letting them fluctuate freely, thus balancing supply and demand. By implication, industrial departments and regional authorities would be deprived of much of their economic power, peasants would be allowed to quit collective and state farms and would receive land and means of production, and state firms would be treated in the same way as cooperatives.

The radical economists wanted to proceed with these reforms quickly so as to make the transition period as short as possible. A gradual, step-by-step reform strategy might be expensive and dangerous, they said, because distortions, costs, and social tensions are inevitable during a period when the old economic mechanism is no longer working but the new one is not yet in place.

Markets Had to Be Regulated

Mechanisms of market regulation were proposed. Markets that were going to be created tomorrow, some radical economists said, inevitably would be highly monopolized in most industries — except, perhaps, agriculture and services. Monopolistic competition would result in a slump in production, price increases, bankruptcies, and a rise in unemployment. Besides, structural shifts in the emerging market economy would necessitate job and occupational changes for many workers, with rising inequalities in income distribution.

To minimize these negative consequences, it was suggested that the Soviet Union adopt a variety of special measures and policies: antitrust legislation and competition policy; labor force policies, including restructuring of the whole system of retraining of employees; strong social policies — unemployment insurance, low-income family allowances, pensions, indexation of fixed incomes, progressive income taxation; and monetary and fiscal policies that would pump excess money out of circulation, establishing a normal central bank and independent commercial banks, and put in place a set of macroeconomic policies.

Funds Had to Be Found to Cushion the Effects of the Transition

Recession was inevitable during the transition period, so it would be necessary to raise funds with which to support living standards and investment in some crucial areas during the economic downturn. Among the various fund-raising methods suggested were internal borrowings, privatization — the selling or leasing of some government property, such as land, equipment, plants, and state-owned apartments — the reduction of military expenditure, the regaining of revenues from sales of vodka by stopping the anti-alcohol campaign started in 1985, international borrowing, and foreign direct investment. Although the radical economists proposed the use of all these methods, some were most enthusiastic about borrowing abroad, which finally became the major item in the discussion.

Those who advocated foreign borrowing used the following logic. Soviet net international indebtedness in hard currency was relatively low (US$26–27 billion in 1987–88) and gold reserves were large (US$25–30 billion). In addition, there were large credits in rubles to developing countries (86 billion rubles at the end of 1989); if the ruble became convertible,

some might be used to repay Soviet borrowing in the West, either directly or by sale in the secondary market for, say US$10 to 20 billion. All these assets would enable the Soviet Union to borrow several tens of billions dollars in hard currency and use them to import consumer goods to saturate the market. Approximate calculations indicated that such funds would be sufficient to permit the major groups of the Soviet populace to survive the transition period without a reduction in living standards.

External borrowing and foreign direct investment seemed to be the preferable ways of raising funds as they would offer the possibility of increasing consumption without major cuts in investment, while all the other ways were associated solely with redistribution of national income. (Internal borrowing and sales of state assets to the public would be good means of eliminating the monetary overhang by transferring forced savings into voluntary borrowing. Strictly speaking, however, they would be inappropriate for counterbalancing the coming reduction of living standards resulting from a slump in production caused by restructuring.)

After five years or so, said the radical economists who proposed this plan, there would be a possibility of repaying debt, as the market economy, emerging after the transition period, would be much more efficient than the old economy.

The existing system was certainly inefficient. In the mid-1980s, nearly 20 percent of the Soviet national income was spent on defense, another 30 percent on investment in fixed capital and inventories, and just 50 percent on consumption. (The corresponding figures for the United States were 7, 6, and 87 percent, respectively.) The same is true of gross national product (GNP): personal consumer expenditure and nondefense government expenditure constituted about one-half of Soviet GNP — compared with 75 percent of GNP in the United States and Canada — while another half was used for investment and defense (see Table 1). Tremendous overinvestment was caused by losses resulting from the very nature of overwhelming centralized planning — a very low capacity utilization rate and extremely large inventories are inevitable in such a system. The losses, whose origins and magnitude are detailed elsewhere,[1] are doubtless indicative of the striking inefficiency of central planning in general and the Soviet economy in particular. The whole economic system had a very low coefficient of useful work: a 1.0 ruble increase of national income resulted only in 0.5 ruble of consumption growth — in market economies, this ratio is normally somewhere between 1:0.7 and 1:0.9.

All this was a clear indication that, as Gavriil Popov once put it, the Soviet economy resembled a car that consumed gas but did not move.

Yet there was another way to look at the extremely high shares of investment and defense expenditure in national income. They signalled not only the inefficiency of the Soviet economy and the magnitude of needed restructuring (see Box 2), but also the presence of a vast reserve for the potential improvement of economic performance. If only the losses associated with excess inventories and idle production capacities could be reduced to the level of those in an average market economy, the better allocation of resources would increase economic efficiency considerably. This increase, together with envisaged cuts in military spending, would provide the Soviet Union with the funds necessary to repay foreign borrowing. Moreover, radical reform in agriculture — returning the land to peasants — would probably increase food production considerably, making food imports unnecessary and thus releasing several billion dollars annually to service international indebtedness.

The Transition Delayed

Clearly, there was no sense in proceeding with foreign borrowing without simultaneous and decisive measures to implement radical changes. If the new market economy was not created during the transition period, the old system probably would swallow all foreign

Table 1: ***Gross National Expenditure by Component in the Soviet Union, the United States, and Canada, 1989***
(percentage of total)

	USSR		United States	Canada
	Official Data	Alternative Estimates		
Personal expenditure on consumer goods and services	48.1	40 to 45	66.3	58.5
Government expenditure on consumer goods and services (without capital outlays)	20.9	20 to 25	15.9	18.6
nondefense	12.7	5 to 10	9.8	16.9
defense	8.1	10 to 15	6.1	1.7
Gross capital investment	31.1	35	19.4	22.6
Net exports and statistical discrepancy	—	-5 to +5	-1.6	0.3

Sources: Goskomstat, Central Intelligence Agency, U.S. Department of Commerce, and Statistics Canada.

credits without any increase in output — much as it did in the 1970s when it ate up petrodollars as increased revenues from oil and gas exports were used to buy grain. In other words, this set of measures was designed as a package. If the whole had been done, it would have been by far the best and most elegant scenario of *perestroika* — a sort of surgery with anesthetic, an easy way of restructuring with the negative economic and social consequences of reform offset with the help of foreign borrowing until the time when *perestroika* began to pay for itself.

This scenario failed to materialize. Radical reforms were never carried out, partly because the government itself chose a strategy of gradual, step-by-step reforms and partly because of bureaucratic resistance, which impeded the implementation of even those laws and regulations that were approved by the Supreme Soviet and the government.

One way or another, the transition to the market economy was delayed to an indefinite future. Meanwhile, virtually nothing was done to create appropriate mechanisms of market regulation. Only in 1989 did the government recognize the necessity of designing laws on competition, banking, and employment, and begin the work of elaborating specific policies in these areas. Probably worst of all, the government decided to finance the increasing budget deficits of 1985 through 1990 by printing money, thus creating terrible shortages of everything and nearly destroying the consumer market, replacing it more and more with a system of rationed supply.

As for foreign borrowing, the government publicly declared its unwillingness to increase it, pointing out that the Soviet Union's international investment position was already bad. No comments were made about the proposal to use gold reserves as collateral — in fact, there are still no official data on Soviet gold reserves. The net international indebtedness of the USSR in hard currency doubled between 1985 and 1989, but this rise was largely the result of dollar depreciation — roughly half of the Soviet debt is denominated in West European currencies and in Japanese yen. An increasing part of hard currency revenue was used for imports of investment, not consumer goods; between 1985 and 1989, Soviet purchases of machinery and equipment in Western countries increased from 5.4 to 7.0 billion rubles, while its purchases of industrial con-

Box 2: *The Economic Costs of Perestroika*

Every major restructuring is accompanied not only by benefits, but also by costs — and the costs unfortunately come first. The reallocation of resources is almost always associated with recession — that is, with the temporary reduction of output — because of the conversion of production from, say, defense to nondefense goods, investment to consumer goods, and so on.

In the Soviet case, the costs of *perestroika* associated with the transition to the market may involve a reduction of output of more than 25 percent. Even with minimal change — that is, assuming that the share of net investment would be, say, halved from 30 to 15 percent of national income, which is still quite a lot for a market economy, and assuming that the share of military expenditure would be reduced from 20 to 10 percent, which is also higher than in any Western country — 25 percent of the national economy (15 percent plus 10 percent) would have to be converted from the production of defense and investment goods and services to the production of consumer goods and residential construction. This is to say, 25 percent of Soviet employees would have to change their occupation. (In fact, the figure would be more than 25 percent, because that estimate does not take into account the inevitable restructuring within the consumer sector resulting from factors such as the elimination of subsidies or the need for restructuring associated with opening up the Soviet economy to international competition.)

sumer goods went down from 1.5 to 0.5 billion rubles.

By 1989, the government found itself with major economic reforms not yet started, but initial positions for those reforms that had seriously deteriorated. The budget deficit had considerably increased, as had internal and external debt. Monetary overhang had become huge, and inflation was accelerating. The partial dismantling of the old system of administrative planning had resulted in distortions and the weakening of work discipline, so production virtually ceased to grow and living standards fell. For 1989, Goskomstat (the State Committee of Statistics) reported a 1.7 percent increase in real industrial output, but given the poor price indexes used in these calculations, it probably meant that there had been no growth at all. (Correspondingly, the U.S. Central Intelligence Agency and the Defense Intelligence Agency estimated that there was no growth in Soviet industry in 1989.) Of 144 important industrial products that Goskomstat constantly monitors, 62 had had physical volumes of output lower than in the previous year. For 1990, Goskomstat reported a 2 percent reduction in GNP and a 4 percent drop in national income. In February 1991, according to Soviet official statistics, industrial output was 5 percent lower than in February 1990.

How to Finance the Restructuring?

Given the urgent need to raise funds for financing the increased costs of *perestroika* and poor economic performance, the government faced several options as the national economy entered the 1990s. It seems useful to discuss these options in terms of ways of financing the budget deficit, since the government budget amounts to more than 50 percent of GNP and is the single most important source of financing the costs of restructuring.

During the late 1980s, the budget deficit grew to more than 10 percent of GNP. Part of this increase resulted from factors beyond the government's control, such as the slump in world oil prices, the Chernobyl disaster, and the Armenian earthquake; part came from the deterioration of economic conditions; and part was the result of mistakes in economic policy, such as the anti-alcohol campaign and the campaign against "unlabor" incomes — that is, restrictions on private trade, cooperatives, and so on. Yet the greatest mistake was the expansionary monetary policy that was pursued from 1985 to 1990, whereby the government financed its increasing budget deficit by printing banknotes instead of by borrowing. As a result, by 1990, there were shortages and a tremendous monetary overhang in the consumer market, so the issue of finding a non-

inflationary way of financing the deficit (or of eliminating it) became really urgent and was widely discussed. The options considered included assigning more of the national income to consumption through cuts in investment, increasing the prices of consumer goods, instituting monetary reform with a new currency, increasing the government's domestic borrowing, privatizing some tangible government assets, encouraging foreign direct investment, and increasing foreign borrowing. This section examines the pros and cons of each option and describes the public's attitude to them.

More Income to Consumption Goods

The idea of redistributing national income in favor of a consumption fund at the expense of an accumulation fund originated from plans for converting the defense industry, which had started to be debated back in 1988, when Mikhail Gorbachev announced the decision to proceed with unilateral cuts in military personnel and expenditure. At about the same time, some long-term and large-scale investment projects, such as canal construction and northern rivers diversion, came under severe public criticism as programs that were not only a luxury but also senseless and even dangerous.

Later, the whole idea materialized in the project of the economic plan for 1990, worked out by the government and approved by the Congress of People's Deputies in December 1989. That plan envisaged reduction of government investment in material production by 25 percent, cuts in imports of investment goods, and reduction of the share of national income going to production accumulation (investment) from 16 to 14 percent. It also included the transfer of a total of 15 billion rubles from industrial construction to housing construction and current consumption in just one year. The same sharp reduction of investment was envisaged for 1991, when its share in national income — including investment in residential construction — was planned to be reduced to 13 percent from the 20 percent expected in 1990.

At first sight, this approach seemed perfectly logical. Since the share of investment in the national income is higher in the Soviet Union than in any other developed country, the accumulation fund appeared to be a huge reserve that was easily accessible; one only needed to reduce investments and use the released resources for consumption needs. Moreover, the whole plan seemed very noble and appealing, as it involved the transfer of resources from industry to agriculture, from heavy to light industry, from military production to civilian needs — the opposite direction from the transfers of the 1930s. Yet things were not as simple as they seemed.

To begin with, the reconversion of any industry in any economy always poses problems. In the United States, for example, military reconversion after the end of World War II was accompanied by reduced overall industrial output for two years running; manufacturing output fell by 25 percent between 1944 and 1946, and the country experienced a deep economic recession.

Besides, any general structural change in a command economy involves higher costs than would occur in a market economy, for the need to readjust long-standing ties is scarcely the strongest point of centralized planning. An excellent example is the recent Soviet experience in converting wine and vodka distilleries into soft-drink factories — and now, back into alcoholic beverages plants; the production of vodka and wine dropped so much more quickly than the manufacture of soft drinks rose that total beverage output — alcoholic drinks, soft drinks, juices, and mineral water — fell until 1987 and had not reached the 1984 level by the end of the 1980s. This experience suggests that conversion of the Soviet defense industry, started in 1989, will not produce tangible results earlier than 1992 or 1993.

Again, the mandated conversion of industrial construction would inevitably cause civilian production to drop during the first year or two, with major upheaval for the entire Soviet

economy. Increased output of consumer goods and higher housing construction rates would fail to compensate for the drop in industrial construction. Most importantly, the cuts in civilian output would threaten to become permanent. Although some major investment projects were useless, even harmful, and deserved instant suspension, the freezing of many others would be fraught with great economic disproportions in the already unbalanced Soviet economy.

A centrally planned economy has specific laws that can cause a backlash no less cruel than that of nature. One such law is that high investments must be made to maintain modest economic growth, for without huge inventories and underloaded facilities a centrally planned economy simply will not function. Another law is that the production of investment goods must grow at a rate higher than the production of consumer goods, since a planned economy is oriented more to itself than to the consumer.

For six decades, the Soviet economy developed with accumulation rates significantly higher than those that are foreseen by the planners for the upcoming years. How, then, could one government or Supreme Soviet decree alone suffice to change everything overnight? Since the share of consumer goods in overall industrial output dropped from 60 percent in 1928 to 25 percent in 1988, was it realistic to plan for a 1990 growth rate for consumer commodity output 13 times higher than the rate for the means of production (6.7 and 0.5 percent, respectively)?

Such a huge planned transfer of resources might end only in shortages of raw materials, energy, and equipment with consequent bottlenecks and an ultimate decrease in the output of consumer goods. This, in fact, is already happening: in January-February 1991, both total industrial output and the production of consumer goods were lower than in the same period of 1990, despite the high priority given to consumer goods production.

It is true that the Soviet economy was — and is — suffocating from excessively high investments. The reduction of investments, however, should be the natural result of a transition to a market economy, where they would take place automatically since the market mechanism for allocating resources — which is more efficient than that of a command economy — would raise the capacity utilization rate and reduce surplus stocks. To try to accelerate the structural reconstruction by issuing orders and prescriptions from above would ruin the whole undertaking. Premature resolutions to make the economy face the people before market relations had been established could lead only to misalignment, chaos, and, in the end, economic recession involving the decline of real incomes.

Increases in Consumer Goods Prices

The Soviet Union has been heavily subsidizing the prices of food — mostly, meat and milk products— for the past 25 years. By the end of the 1980s, these subsidies amounted to 100 billion rubles annually.

Wide discussion of the issue, from the very beginning of *perestroika*, revealed that virtually everybody was against price increases even if accompanied by direct money compensation (see Box 3). This sentiment led the government to promise, at the beginning of 1989, that prices for basic consumer goods would remain unchanged for the next two or three years. In fact, in November 1989, *Pravda* reported that Gorbachev had gone so far as to state that "in two weeks [an unregulated market] will force the people to get into the streets and will wipe out any government."

Nevertheless, in May 1990, the government declared a program of price increases for all goods, including consumer goods. The proposal, which was to take effect on January 1, 1991, was to increase retail prices for consumer goods and services — thus bringing in extra annual revenues of 200 billion rubles — and simultaneously to provide 135 billion rubles in annual compensation to consumers. (The figures implied the doubling of food prices

Box 3: *The Soviet Public's Attitude to Price Increases*

Several years ago, the majority of academic economists were against consumer price increases, but even then there were some who favored the immediate deregulation of all prices, including those of basic consumer goods — one would call them Soviet supply-siders. There have also been some interesting regional variations in sentiment.

In fall 1989, the Supreme Soviet voted against proposed price increases for cigarettes, alcoholic beverages, and some consumer luxury goods, but the Estonian parliament approved such increases. At the end of 1990, Estonia increased prices considerably, and so did Latvia and Lithuania at the beginning of 1991. In Lithuania, though, this action caused strikes and unrest that forced the government of Kazimira Prunskene to resign.

It may be argued that egalitarian feelings are not so widely spread in Estonia — and in other Baltic republics, which have the highest living standards in the USSR — as in Russia and other areas, and thus that in a shortage situation, people in the Baltics tend to be more willing to accept equilibrium prices, while in other, less wealthy regions people prefer rationing. Interestingly enough, soon after Estonia raised liquor prices, alcoholic beverages disappeared in the Leningrad region, which borders on Estonia, because profiteers were buying liquor in Leningrad and selling in Estonia. So, in 1990, the new Leningrad authorities introduced rationing.

During the course of 1990, attitudes to price increases changed rapidly. When the government program was proposed in May 1990, consumer panic developed. Virtually everything that could be stored, from noodles to groats, disappeared from the shops. In Moscow and other places, a passport system of trade was introduced. The longer people lived in such a poor environment, the more they realized that there were only two ways out: complete rationing or price increases. The idea of price increases was supported only by a minority — mostly wealthy individuals — in early 1990. By the end of 1990, it seemed quite probable that most people would be willing to accept price deregulation for most consumer goods together with rationing of some basic foodstuffs, such as bread, butter, and meat.

On July 23, 1990, *Izvestiya* reported the results of a poll of nearly 3,000 individuals conducted in Moscow earlier that month. It revealed that 45 percent preferred rationing, 27 percent free market prices, 7 percent "social money" — part of a salary paid in certificates, which may be used only to buy low-priced goods in state shops — and 5 percent increases with compensation, as in the government program. Sixteen percent had no opinion. It is worth noting that the group that favored rationing included a relatively high percentage of individuals with lower educational levels and social status — unskilled workers, pensioners, and housewives.

and price increases for non-food consumer goods and services in the range of 20 to 70 percent.) It was also suggested that bread prices be increased almost immediately (starting on July 1, 1990) with full compensation to consumers.

But the Supreme Soviet did not support the program. The proposal to increase bread prices was rejected completely. The other proposals were heavily criticized, and the final verdict was that they should be redesigned and brought back to the Supreme Soviet for reconsideration in September 1990.

It is difficult to say whether the deputies turned down the government proposals because of egalitarian feelings — reflecting those of the voters — or because of an understanding that market-type reforms should envisage deregulation of prices rather than a sort of bureaucratic game. (Both types of arguments were used during the debates in the Supreme Soviet.)

As the situation in the consumer market worsened, more and more regional and republican authorities introduced rationing, protectionist measures, and higher prices for some consumer goods. In August and September 1990, a "cigarette crisis" developed, with angry smokers trashing empty tobacco kiosks all over the country; the response in some places was rationing of cigarettes — in Moscow, to five packs a month. In November 1990, prices for some "luxury" goods — jewelry, furs, electronics, auto parts, and furniture — were deregulated all over the country by presidential decree, while Ukraine established a form of

republican "social" money and the Leningrad city council decided to ration food starting from December 1.

A redesigned government program was submitted to the parliament in September. It envisaged the same sort of administrative price increases as had been proposed in May, but this time with 100 percent compensation to consumers, which made the whole plan senseless from all points of view. The Shatalin program, supported by the democratic opposition, was also released in September 1990; it proposed deregulation of 70 percent of goods by the end of 1991. In October 1990, however, the Supreme Soviet approved a third program, presented by the president himself and vague on the issue of price reform. (The Supreme Soviet refused other aspects of the plan in May 1990; the three plans presented to it that fall are described later in this *Commentary*.)

In March 1991, the government nevertheless announced a program of price increases to go into effect on April 2, 1991. Prices were increased on average by 60 percent; some of them were deregulated entirely. Compensation payments from the central government budget were set at a level of 50–60 rubles a month for every employee and pensioner — equivalent to 20 percent of an average monthly wage — and the first payments were made two weeks before the price increases came into effect.

While there is still insufficient information to evaluate this recent price reform accurately, preliminary calculations indicate that its impact on the monetary overhang will be limited, so that delayed demand will not be completely absorbed by the increased value of sales. Also, this was an administrative rather than a market-oriented price reform, as most prices were set at new levels, not deregulated.

Monetary Reform

Monetary reform was another issue widely discussed in the Soviet Union in 1989 and 1990 (see Box 4). The proposal was to exchange the old currency for a new one: up to a certain amount at the ratio of 1:1, and larger amounts at 1:10 — unless the individual could prove the money had been earned in a legal way. Most radical economists strongly oppose such a move, pointing out that its advantages will be outweighed by its costs. Recently published data on the distribution of savings reveal that of 300 billion rubles of demand and saving deposits in the Saving Bank at the beginning of 1989, only 30 billion were in accounts exceeding 10,000 rubles (roughly the price of a car). Thus, even if the government decided to confiscate all savings in excess of 10,000 rubles, it would gain just 30 billion rubles — only 30 percent of its budget deficit in 1989. And in doing so, the leadership would lose the confidence of the Soviet middle class, the people who are the major driving force of *perestroika* and most socially active. Surely the confidence of the middle class, as well as the general belief that property rights should not be violated, is worth much more than 30 billion rubles.

Even from a purely pragmatic point of view, monetary reform is a game that is not worth the candle. History has seen cases in which excessively large money circulation compelled a government to replace old, devalued currency with a new one issued in lesser amounts. Examples include the 1797 reform in France, in which all banknotes issued by the revolutionary government were canceled; the Soviet monetary reforms of 1922–24 and 1947; the 1924 reform in Germany after the hyperinflation during World War I; and reforms after World War II in several European countries, such as that in West Germany in 1948, when the U.S., British, and French occupation authorities changed the old mark for the new deutschemark at the ratio of 10:1. Yet in all those cases, the monetary reforms followed both major political upheavals and rapid devaluation (100 percent or more annually). Only under such conditions can the advantages of the monetary reform exceed its costs. In the recent past, even countries, such as Israel, Yugoslavia, and many Latin American states, that have suffered annual inflation of

Box 4: *Who Supports Monetary Reform?*

Until recently, monetary reform was advocated by the extreme right wing — those associated with trade unions, the United Front of Workers, and an organization called Pamyat (Memory). They claimed that *perestroika* was leading to a restoration of capitalism, that the Soviet Mafia and the underground economy were gaining power, that the cooperative sector was producing new Soviet millionaires linked to illegal activity, and so on.

In late 1989 and early 1990, Gavriil Popov and Boris Yeltsin, two of the leaders of the Interregional Group of Deputies, which is on the left of the political spectrum, gave their support to the reform. Shortly afterward, they limited their support for the idea, which was unpopular (on different grounds) among intellectuals and new Soviet entrepreneurs (co-op members). (It may be of interest to note that A. Sergeev, a rightist economist from the High School of the Trade Union Movement, accused Yeltsin and Popov of stealing the idea from the rightists, saying that it did not fit into their leftist program and that it was simply popular with the masses.)

The advocates of monetary reform claim that 99 percent of the population support the idea. Although there were no public opinion polls on this issue, the figure may be quite close to reality.

The rightists support the idea of a monetary reform mostly on egalitarian grounds, claiming that large inequalities in income distribution, which became more pronounced during the *perestroika* years, are unfair and need to be eliminated. The leftists' flirtation with the idea seems to be a short-term phenomenon reflecting strong populist trends, which are quite common in societies with no firm democratic traditions.

hundreds of percent have not changed their currency; the reason is that the costs would have been too high, and the inevitable violations of social justice would have undermined the people's confidence in the government. In democratic societies, the result would have been electoral defeat of the government; in societies with underdeveloped democratic institutions, the consequences could have ranged from strikes and street disturbances to emigration.

The USSR still faces neither 100 percent inflation nor a major political upheaval. The ruble devaluation rate, even accounting for the growing gap between money demand and commodity supply not covered by price rises, did not exceed 20 percent in early 1991 and delayed consumer and investment demand is still at least two times less than GNP. These figures are not so high as even to consider discounting the old currency and printing new bank notes. The country has no need to look like a sloven who believes that producing new offspring would be easier than washing her children.

Unfortunately, in January 1991, despite numerous previous statements that the government was not planning any monetary reform, part of the nation's cash money was withdrawn from circulation by a presidential decree. All 50- and 100-ruble banknotes were declared invalid, and Soviet citizens were given only three days to change them into notes of smaller denominations. Also, personal banking accounts were partially frozen by limiting cash withdrawals in a month to 500 rubles — approximately two months' wages for the average Soviet worker.

It was assumed that black marketeers would not be able to exchange their cash savings, so social justice would be restored and monetary overhang would be reduced. Yet the net gains possible from this reform seem modest. Of the more than 120 billion rubles of cash in circulation, 46 billion rubles were in 50- and 100-ruble notes, and only 7–15 billion rubles of them were thought to be in the hands of black marketeers. In practice, the people hurt by the reform are the many senior citizens who were keeping their money "under the mattress" and have now seen their lifetime savings eliminated. Moreover, a 7–15 billion ruble reduction of the monetary overhang — currently estimated at more than 200 billion rubles — is hardly noticeable.

Domestic Borrowing

At first thought, an increase in government domestic borrowing seems a positive development. The value of government bonds held by the population is negligible — less than 25 billion rubles. Until recently, enterprises, cooperatives, and organizations did not hold government bonds at all, and the volume of newly issued bonds purchased annually by individuals amounted only to 1 or 2 billion rubles in recent years. So long as the interest rate offered is relatively high, to protect investors from ruble devaluation, internal borrowing may help to ease the monetary overhang and to assure the transition from forced saving to voluntary saving.

Yet measures to stimulate internal borrowing have shortcomings. They do not affect substantially the balance between saving and investment, but only transform forced saving into voluntary saving. At best they may cause a slight increase in saving at the expense of somewhat reduced consumption of so-called accumulation goods — gold, jewelry, antiques, real estate — that are used as a substitute for financial assets.

In 1990, the government offered individuals 5 percent bonds totaling 15 billion rubles, and "commodity bonds" — giving the right to buy goods in shortage — totaling 10 billion rubles. It also offered 5 percent bonds totaling 60 billion rubles to enterprises, co-ops, organizations, and banks. Yet even provided those bonds were sold, the government still needed to print 10 billion rubles of new money (down from 18 billion in 1989). There were also fears that the 5 percent rate might not be attractive enough to hold money growth to the amount envisaged. In fact, by the end of 1990, the sales of bonds to individuals totaled only 0.5 billion rubles, even though the interest rate on these bonds had been increased in November 1990 up to 10 percent, and the sales of bonds to enterprises had brought in only 20 million rubles. The decision to increase interest rates came too late and was not radical enough; by that time, inflation was running at more than 10 percent and everybody expected price increases to accelerate. Meanwhile the 1990 increase of cash in circulation totaled more than 25 billion rubles.

Privatization

Selling and leasing tangible government assets to enterprises, co-ops, and individuals looks like a promising fundraising method. There is an enormous amount of state property, there are persons and companies willing to buy or rent it, and there will evidently be more such requests as market relations are developed. The constraint is that private enterprise is a new idea in the Soviet Union and the rules are still shifting (see Box 5). Until recently, there was no private ownership of land, and individuals were prohibited from buying equipment and structures for production operations that were larger than a family business.

The population is still very cautious and suspicious about private property (see Table 2). So are party bureaucrats. The latter have taken an especially hard stand on the issue of private farming. At the Twenty-Eighth Congress of the Communist Party, held in July 1990, 73 percent of the delegates — nearly half of whom were professional party bureaucrats — stated that they were against selling land to private persons, and an overwhelming majority argued that collective and state farms had the best prospects for the future. Only 12 percent associated these prospects with independent farms. In contrast, 24 percent of the population regards the independent farm as the agricultural unit that has the best prospects for the future. The chairs of collective farms and directors of state farms are also conservative on the issue of private property. The new Peasant's Union, formed in June 1990 and dominated by directors of state farms and chairmen of collective farms, considers independent farming a supplementary form of agricultural organization that should never predominate. It pushes strongly for increased investment for collective and state

Box 5: *Does Soviet Law Allow Private Property?*

Soviet conservatives consider the legalization of private property to be the final step across the line separating socialism and capitalism. In contrast, the radicals have been pushing hard for the removal of all ideological constraints that contradict common sense and impede the growth of efficiency. The tension between the two viewpoints has slowed legal changes.

The Land Act, approved by the Supreme Soviet in February 1990 and put into effect after March 15, allowed farmers to lease land from the state with lifetime tenure and to pass it on to descendants. Ownership, however, remained prohibited; plots could not be bought or sold, nor could they be used as collateral when obtaining credit. Nevertheless, in December 1990, the parliament of the Russian republic adopted, after hard debate, a law allowing private ownership of land; plots cannot, however, be sold for ten years after purchase.

The Law on Property, approved by the Supreme Soviet in March 1990 and put into effect on July 1, allowed private ownership of "small" enterprises for family members and "other persons who jointly operate labor-based business." In July 1990, however, the government passed a decree allowing small private businesses — up to 200 employees in industry and construction, 50 employees in most other industries, and 25 employees in local industries and services.

In June 1990, a government decree allowed the transformation of state enterprises into stock companies with the possibility of individuals and other companies buying part of the shares. However, in order to provide a considerable contribution to government revenues, this measure should be accompanied by the simultaneous elimination of obligatory production quotas and rationing of resource supply as well as by deregulation of prices. It is doubtful that potential shareholders would be willing to accept the uncertainties of holding stock in companies whose gains and losses are determined not by a market but by government decisions on production quotas, resource supply, and prices for inputs and outputs.

farms, arguing that this is the best way to improve productivity in agriculture.

Foreign Direct Investment

An inflow of foreign direct investment would be the ideal way to finance the costs of economic restructuring and provide badly needed foreign currency. At least theoretically, this inflow could be very large, since the Soviet Union is probably the last important area in the world with virtually no foreign direct investment. Yet foreign investors currently face many obstacles in the Soviet Union, so a considerable inflow of funds seems unlikely in the near future.

During the four years after January 1987, when a decree allowing joint ventures in the Soviet economy was issued, more than 2,000 such enterprises were established with more than US$2 billion foreign direct investment. In 1989, these joint ventures produced goods and services valued at 1 billion rubles; the estimated figure for 1990 was 2 billion rubles. These amounts are still very small, the reasons being bureaucratic red tape, difficulties with supplies, a lack of guaranties for safe operations and profit transfers, the unstable investment climate, and, most importantly, the inconvertibility of the ruble. Only in the fall of 1990 were joint ventures and foreigners allowed to participate in foreign-exchange auctions, which had been taking place periodically during the two previous years, but on a rather small scale — tens of millions of rubles.

The Shatalin program proposed allowing all companies operating inside the country — Soviet-owned firms, joint ventures, and foreign enterprises — to exchange rubles and hard currency without any limitation, using market exchange rates by the end of 1991, after the deregulation of major prices. The government has taken a much more cautious approach, providing no time schedule for convertibility. On November 1, 1990, it introduced a new official exchange rate of 1.8 rubles per U.S. dollar — a devaluation from 0.6. A presidential decree made it obligatory for enterprises to exchange 40 percent of their hard currency earnings for rubles to ensure that the government has enough hard currency to ser-

Table 2: ***Opinion Polls on Private Property Rights***
(end of 1989 and beginning of 1990)

	Percentage of Respondents
1. Support the idea of private enterprise?	
Yes	47
No	15
2. Should private companies have the right to hire?	
No	42
Yes, limited to a small number (say, 10)	12
Yes, limited to substantial number	13
Yes, without restriction	13
3. Support individual use of land?	
Yes	87
No	10
4. Support granting the right to buy and sell land?	
Yes	24–26
No	50
5. Peasants	
Want to become independent farmers	10–14
Wish to have individual plots	40
Want land but fear it will be taken back	30–33
Don't ever want to own land	10
6. How do you evaluate the performance of new cooperatives?	
Positively	15
Negatively	29
Mixed feelings	56

Sources: Questions 1 and 2, *Izvestiya*, February 26, 1990; questions 3 through 5, *Izvestiya*, February 28, 1990; question 6, *Economika i zhizn*, November 2, 1990.

vice increased Soviet international indebtedness. At the same time, the rightists are trying to prevent the selling or even the leasing of land to joint ventures, considering it "selling out the motherland."

Foreign Borrowing

As in the earlier years of *perestroika*, an increase in foreign borrowing seems the preferable means of raising funds. The problem is that the Soviet Union's ability to borrow in international capital markets has deteriorated, as it is now considered a risky borrower. The 1989 miners' strikes, followed by increased national tensions and unrest, created doubts among Western creditors about the ability of the Soviet leadership to control the maelstrom of events. The payments difficulties that arose from the end of 1989 — some Soviet companies and trade associations were not paying for import deliveries — undermined the country's creditworthiness even more. By mid-1990, the Soviet Union's trade arrears — delays in payments for import deliveries — totaled several hundred million dollars, and the country was using gold as a collateral for US$3 billion worth of credits. By March 1991, unpaid commercial invoices were approaching US$5 billion. The debt-service ratio was expected to increase from 24 percent in 1989 to 33 percent in 1990.

Meanwhile, the need for external funds increased as the Soviet economy entered a recession with a huge monetary overhang and a large government budget deficit. It is now doubtful that tens of billions of dollars, even if they can be borrowed in the West, will be enough to allow a smooth transition to a market economy without a considerable reduction of living standards. In September 1990, Prime Minister Nikolai Ryzhkov stated that hard currency revenues in 1991, after subtracting 12.5 billion rubles needed to service the debt, would allow the Soviet Union to pay only one-third of what it paid for imports in 1990. Recent studies of the Soviet economy prepared by the International Monetary Fund and the European Community estimate that the Soviet Union will need US$22–27 billion in 1991 just to finance the current account deficit, amortization, and interest payments on existing hard currency debt.[2]

There was and still is a possibility of Western financial assistance (see Box 6). Savings of hard currency were also to be had by reducing Soviet assistance to developing countries — it was planned to decrease it from 12.5 billion rubles in 1989 to 9.7 billion in 1990 — and by converting part of Soviet credits to socialist and developing countries into hard currency. More hard currency will be gained from Comecon countries, as all trade is now conducted in world prices and convertible currencies. But the amounts are not nearly enough.

Until mid-1990, the government was not willing to increase foreign borrowing, claiming that the people would not accept it. In June 1990, Deputy Prime Minister and Chairman of the Commission on Economic Reform Leonid Abalkin stated:

> The price of concessions that we may be demanded to make [in exchange for assistance] is high enough....The existence of two [social] systems is not an ideological myth, but a reality. If this issue would be decided at a referendum, I have strong doubts about a positive reaction. I know that anti-market feelings are quite widespread in this country and if all these conversations about "selling out the motherland" were added to these feelings, the people would hardly accept such an option....We must rely mostly on ourselves.[3]

Nevertheless, a month later Gorbachev sent a letter to U.S. President George Bush, asking for "assistance with credits, which may help the reforms."[4] Yet Ryzhkov, in presenting the government program to the Supreme Soviet in September 1990, in effect denied foreign assistance:

> We can't hope for multibillion Western money assistance to finance mainly current consumption. It is quite doubtful that in this way we'll be able to pass the social costs of the transition to the market to foreign countries. Also, it is not clear how we are going to pay back these loans in future.[5]

In contrast, the alternative program prepared by the democratic opposition — the Shatalin group — called for starting negotiations with major Western countries and international organizations right away (in October 1990) "to get the assistance and long-term credits for such a collateral as a reforms program. The negotiations may lead to a new Marshall plan."[6] The Shatalin program mentioned US$10–20 billion as a possible amount of Western financial assistance; in October 1990, Nikolai Petrakov, Gorbachev's economic adviser, spoke about at least US$10–12 billion.

Recent Developments and Future Options

The March 1990 elections to the Russian Supreme Soviet and to the legislatures of other republican and local soviets created a new political situation that has greatly influenced the process of economic reforms. In Russia, the democratic bloc got more than a quarter of the seats, and Yeltsin was elected as chairman; in Moscow, Leningrad, and other major cities, democrats were elected mayors; and in other republics and local soviets, radicals strengthened their positions considerably. From that time on there has developed a sort of schism between many republican governments and local authorities, which are inclined to be radical, and the central government, which has

Box 6: *Western Financial Assistance*

Financial assistance for the USSR has been much discussed in the West — for example, during the seven-power summit in July 1990. During that year, West Germany provided $12 billion in credits and financial assistance, the larger part of it for paying the costs associated with the withdrawal of Soviet troops from East Germany, including residential construction for military personnel coming back to the USSR. Smaller credits came from other Western countries, and the Bank for European Reconstruction and Development was set up to finance reforms in the East European countries and the USSR. (The Soviet Union, however, cannot borrow more from the Bank than it contributes to it in the first three years.)

While Germany was pushing hard for providing financial assistance for Gorbachev's reforms, the United States and the United Kingdom were much less enthusiastic about the idea, insisting that the Soviet Union should first cut its defense expenditure and stop military aid to Cuba and other allies. Nevertheless, as fears for a hungry 1990/91 winter increased, Germany started food shipments to the USSR, and some other countries took similar steps. But in response to the military crackdown in the Baltic republics in January 1991, some Western countries suspended their assistance plans. Canada withdrew a $150 million credit line, while the European parliament blocked a $1 billion food aid package.

continued to follow a more conservative course. This new situation imposed pressure on the central government, as the republican governments and local authorities began to seek greater power and independence in order to implement radical reforms that it had failed to put in place for years.

At the same time, the idea that radical restructuring inevitably will be accompanied by a considerable temporary reduction of living standards gradually began to penetrate the public consciousness. The government program submitted to the Supreme Soviet in May 1990 envisaged two scenarios for Soviet performance during the transition to a market economy during the 1991–95 period. The first, labeled "shock therapy," involved immediate deregulation of major prices; GNP, employment, investment, and real incomes would fall quite sharply in 1991 but climb back thereafter, with GNP hitting 144 to 150 percent of its 1990 level by 1995 (see Table 3). The second, based on less-restrictive monetary policy and gradual, rather than immediate, elimination of price controls, predicated a lesser economic slump in 1991 but a slower pace of recovery, with a 1995 GNP of only 25 to 35 percent of its 1990 level.

In presenting the two options to the Supreme Soviet in May 1990, Prime Minister Ryzhkov said that the first was not acceptable from the social point of view, so the government was backing the second. But the deputies considered that one inappropriate too. "This is a shock without a therapy," said People's Deputy Pavel Bunich, a well-known radical economist.[7] As already noted, the Supreme Soviet rejected all the proposals before it and asked for a redesign.

The 500-Days Program: The First-Best Option

When the issue came to the Supreme Soviet again, in September 1990, the options for transforming the Soviet economy and financing the restructuring had materialized into two distinctly different programs, one put forward by the conservatives (bureaucrats) and the other by the radicals (democrats).

The first, designed by the government and called the Ryzhkov program, was simply a modified version of the program that had failed to get the support of the Supreme Soviet in May. It was more radical on the issue of privatization — by that time, the Council of Ministers had issued decrees allowing private businesses with 25 to 200 employees and the transformation of state enterprises into limited companies — but it was still based on an old approach to price reform: administrative manipulation of prices and compensation, in-

Table 3: ***The Two Restructuring Scenarios Presented by the Government to the Supreme Soviet, May 1990***

		Shock Therapy	Gradual Change
		(percentage change from 1990)	
1991	GNP	–10 to 15	–5 to 9
	Employment	–5 to 7	–3 to 5
	Investment	–50	–14 to 19
	Real incomes	–4 to 7	–1 to 3
1995	GNP	+44 to 50	+25 to 35

stead of deregulation of prices. The government recognized by this time that the economy was rapidly sliding into a recession. By Ryzhkov's own estimate, if no measures were taken, industrial output and national income would decrease by 15 percent and investment in material production by 35 percent in 1991. Yet the Ryzhkov program still did not envisage the creation of a true market-type economy, as there can be no market with fixed prices.

In contrast, the radicals' program — often called the 500-days program — was, by and large, a real plan for radical market-type reforms. Prepared by a group of economists headed by Stanislav Shatalin, which had been created by a joint decision of Gorbachev and Yeltsin, it was based on the blueprint described earlier. It envisaged decisive measures for financial stabilization — privatization of state enterprises, internal borrowing, sales of state apartments and gold reserves, and so on; rapid dismantling of central planning — elimination of obligatory production quotas and the rationed supply system plus deregulation of prices; truly radical agrarian reform; creation of an appropriate "market infrastructure" — a new banking system, antitrust legislation and competition policy, and a social security net; and borrowing abroad, asking for financial assistance from the West, and finding other ways of obtaining foreign currency to finance the costs of transition.

The Shatalin program was supported by most, if not all, of the republics, as it envisaged a considerable decentralization of economic power and thus provided a real chance of preserving the all-union monetary system, keeping the ruble as the single currency for all the republics, and avoiding the disintegration of the emerging Soviet market.

The immediate implementation of the Shatalin program was definitely the preferable option — the first-best option, so to say — as it allowed for rapid shock-therapy treatment of the economy on the basis of consensus between republics. It would have avoided continuing the pain and cost of the command economy and would have ensured that the rules for restructuring were not changed constantly, misleading enterprises and individuals and inhibiting the elaboration of long-term adjustment strategy.

This is not to say that the Shatalin program was cost-free. In fact, one must take with extreme caution the program's own predictions: a temporary and quantitatively unspecified reduction of output during the first 400 days and an increase in unemployment from 6 million in 1990 to 12 million by the end of 1991. The program's promise of a stabilization of living standards during the transition period was just wishful thinking; government estimates that implementation would have led to a reduction of living standards of 30 percent or more may have been closer to reality. Nevertheless, the costs of this "shock therapy" would have been lower than those resulting from the Ryzhkov program of step-by-step reforms.

Unfortunately, Shatalin's plan was not implemented. Gorbachev, who had given definite support to it earlier, then backed a combination of Shatalin's and Ryzhkov's plans. In

October 1990, this new presidential plan, liberal in essence and very vague and general in form, was approved by the Supreme Soviet.

The Balkanization of the Soviet Economy

The failure of the Shatalin plan forced the republics to abandon the idea of economic compromise and to seek their own way out. Russia and many others stated their intention of pursuing the 500-days plan (or something similar), no matter what the policy of the central government. At the beginning of November 1990, Ukraine introduced a sort of republican social money: 70 percent of a worker's wages were now paid not only in rubles but also in coupons, and the two had to be used together for purchases of consumer goods. Other republics and regions started to take similar steps, giving additional stimulus to the balkanization of the Soviet economy.

Finally, in November, the economists who had worked out the 500-days plan, including Shatalin himself, made an open statement that their program was no longer feasible. The republican governments, they said, no longer believed in the economic union and a common market managed by the central authorities, but now relied on protectionist policies. Meanwhile, the all-union government increased wholesale prices, instead of promoting financial stabilization, and was thus stimulating the economic separatism of the republics.

By the end of 1990, there was little hope that the republics and the central authorities would make joint, coordinated efforts to ensure radical market-type reforms. The Shatalin plan, the first-best option, appeared dead. Still, there seemed some chance for the second-best option: a gradual transition to a market economy carried out by presidential decrees without a major clash between the central government and the republican and regional authorities. This scenario implied that either republican governments would hold back their demands for greater economic independence or the central authorities would somehow ensure that various regions and republics would not proceed with economic separatism. Stretching the transition period would definitely entail higher restructuring costs than shock-therapy *perestroika*, but it might well avoid the burden of regional disintegration.

The alternative was the economic disintegration of the union and the emergence of many different markets separated by currencies, custom duties, and other trade barriers, as the republics and smaller regional units proceeded with implementing their own distinct reform programs. The costs of this third scenario were obvious: the central government, the republics, and regional authorities would be engaged in a disastrous fight over the distribution of economic power — a fight that would likely absorb time, effort, and energy that otherwise would have been invested in much-needed reforms. Introducing separate currencies and tariff and nontariff trade barriers would carry high direct costs and cause an expensive restructuring of existing interregional trade flows. Prospects for Western financial assistance, direct investment, and credits would become more uncertain.

Nevertheless, as 1990 came to an end, events were definitely developing along the lines of the third scenario. One by one, the more radical-minded republics were opting for full economic independence in order to ensure having enough power to implement radical reforms. The president was unwilling, or unable, to accept the democratic bloc's ultimatum to follow Shatalin's program, while the democrats were not prepared to compromise with the president by supporting his program of gradual reform. The paradox was that in pushing so strongly for the first-best option, the democrats — that is, the republican and regional authorities highly influenced by the democrats — speeded development along the lines of the third, most painful scenario.

The Strengthening of Political Conservatism

Developments in January 1991 created a completely different environment for economic *perestroika*. With liberals replaced by conserv-

atives in key government positions, with media censorship tightened, and with the military starting an open fight against republican authorities in the Baltic republics and beginning to patrol major cities, Soviet politics moved to the right. No temporary episode, this recent shift means that the army, together with the KGB and the military-industrial complex, has established itself as a major force in Soviet politics, making it clear it will not rule out the use of force to prevent the disintegration of the union.

These authoritarian trends will probably strengthen in the foreseeable future, so there is virtually no hope that the conflict between the republics and the central authorities will be resolved in a democratic way. It is not easy to predict how far the conservative wave will spread or to what extent political freedoms and the *glasnost* policy will be limited. But on the whole there is little doubt that from now on the political environment for economic reform will be authoritarian rather than democratic.

An all-union referendum held on March 17 revealed major support for the federal state in nine out of 15 republics. The voter turnout rate ranged from 75 to 98 percent, and those voting in favor of the Union ranged from 70 percent in Ukraine to 98 percent in Turkmenistan (see Table 4). Yet, six republics did not participate in the referendum — the three Baltic republics, Armenia, Georgia, and Moldova. The plebiscites held previously (February-March 1991) in the Baltic republics gave strong support to the idea of secession — 75–90 percent of those voting for separation, with a participation rate ranging from 33 to 88 percent; similar results may be expected in Armenia, Georgia, and, probably, Moldova. The issue of separation will certainly remain a high priority in these republics in the foreseeable future, and conflicts with the central government over this issue are inevitable. The possibility of introducing direct presidential rule and martial law in some of the republics cannot be dismissed completely.

What does this new political setting mean for economic restructuring? One is that the last of the three options that existed at the end of 1990 — the scenario involving the disintegration of the common Soviet market — is now much less likely. Only several months ago, this scenario seemed to be the most probable one, but now it is hard to see how republican and local authorities can continue to pursue greater economic power and independence without driving themselves into serious trouble.

Nevertheless, the other two options are still open, and it now remains to be seen whether the new leadership will be willing to proceed with shock-therapy treatment or opt for a cautious, gradualist approach. On the one hand, the centralization of power that is now taking place will make it easier for the government to implement *any* type of reform it considers appropriate. The political obstacles to radical market-oriented restructuring are fewer. On the other hand, the new officials do not seem to be radical reform-minded; they are mostly state bureaucrats who have been associated with and responsible for the government policies of recent years. Needless to say,

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This publication can be obtained from: Renouf Publishing Company Ltd., 1294 Algoma Road, Ottawa, Ontario K1B 3W8 (tel.: 613-741-4333; fax: 613-741-5439), or from Renouf's stores at 61 Sparks Street, Ottawa, Ontario (tel.: 613-238-8985) and 211 Yonge Street, Toronto, Ontario (tel.: 416-363-3171).

Quotation with proper credit is permissible.

$6.00; ISBN 0-88806-279-6

Table 4: ***The Soviet Republics: Population and Regional Economic Disparities, 1989–90***

	Language Group	Dominant Religion	Population	Population Structure			Retail Sales per Capita	Personal Income per Capita	March 1991 Referendum	
				Nationals	Russians	Others			Turnout Rate	Voting for the Union
			(millions)		*(percent)*		*(USSR = 100)*		*(percent)*	
USSR			288.6	100.0	50.9	49.2	100.0	100.0	80	76
RSFSR (Russia)	Slavic	Russian Orthodox	148.0	81.3	81.3	18.7	110.1	108.3	75	71
Ukraine	Slavic	Russian Orthodox/ Greek Catholic	51.8	72.4	21.9	5.7	94.3	100.1	83	70
Byelorussia	Slavic	Russian Orthodox	10.3	79.0	13.1	7.9	110.9	107.8	83	83
Lithuania	Baltic	Catholic	3.7	79.2	9.3	11.5	128.3	117.1	84*	9*
Latvia	Baltic	Lutheran/ Catholic	2.7	51.8	33.8	14.4	146.2	116.2	88*	25*
Estonia	Finno-Ugric	Lutheran	1.6	61.4	30.3	8.3	154.0	120.8	83*	21*
Armenia	Caucasian	Armenian Orthodox	3.3	94.0	1.6	4.4	90.3	87.9	Referendum to be held on Sept. 21, 1991	
Georgia	Caucasian	Georgian Orthodox/ Moslem	5.5	69.5	6.2	24.3	86.6	95.5	90*	1*
Azerbaijan	Turkish	Moslem	7.1	82.5	5.6	11.9	57.9	77.5	75	93
Kazakhstan	Turkish	Moslem	16.7	41.7	37.6	20.7	83.1	92.1	89	94
Uzbekistan	Turkish	Moslem	20.3	66.1	8.3	25.6	58.7	68.3	95	94
Turkmenistan	Turkish	Moslem	3.6	71.9	9.5	18.6	68.0	73.8	98	98
Kirghizia	Turkish	Moslem	1.1	52.0	21.4	26.6	68.5	74.5	93	94
Tadjikistan	Persian	Moslem	5.2	62.1	7.6	30.3	52.0	64.7	94	96
Moldova	Romanian	Russian Orthodox	4.3	64.4	12.9	22.7	90.5	92.7		

* Republican polls were organized by republican authorities on February 9, 1991 in Lithuania, on March 3, 1991 in Latvia and Estonia, and on March 31 in Georgia. Their results are not considered valid by the all-union government.

Sources: Goskomstat and newspaper reports.

Box 7: *The Political Environment for Market-Oriented Restructuring: Authoritarianism versus Democracy*

The conservative renaissance in Soviet politics does not mean that the economic reform process is over or that market-oriented restructuring will come to an end. An authoritarian regime is neither preferable to democratic political rule nor inevitable for the period of transition from a command economy to a market-oriented economy. Nevertheless, the recent experience of countries such as Turkey, South Korea, and Chile shows that an authoritarian system does not preclude market-type reforms.

In the USSR, the profound economic and political changes initiated by Mikhail Gorbachev and, even more important, the tremendous shift in public consciousness that occurred during the *glasnost* period are now irreversible. It is hard to imagine that the country could return to the system that existed prior to 1985.

Yet it does appear that an authoritarian regime is a reality and will remain in place for at least several years. The chance to combine economic reforms with ongoing political democratization has been missed. Gorbachev himself, making compromises with the conservatives, should be regarded primarily as a tragic figure — as a politician trying to avoid greater sacrifices by agreeing to smaller ones. Leaving emotions aside, one should admit that Gorbachev is now a constraint on the military and other conservatives. Demands for his resignation by the radicals might well result in his replacement with a more rightist or less influential politician who would be easily manipulated by conservatives.

these policies were not radical enough and involved a lot of mismanagement.

In fact, the first major economic measures of the new leadership do not look encouraging. The January 1991 presidential decree, imposing confiscatory monetary reform and giving the KGB the right to enter any business enterprise (including joint ventures) and carry out on-the-spot audits of accounts, stocks, and cash, have certainly not contributed to a transition to the market economy. The same is true of the April 1991 price reform: it proved to be a slightly modified version of the previous government plan aimed mainly at setting new prices and income proportions within the framework of the administrative system, but having little to do with the market economy.

Nevertheless, the monetary and price reforms will certainly contribute to eliminating the monetary overhang and thus make it easier for the government to proceed with price deregulation and other market-type reforms. The issue, therefore, is whether the government will be willing to use its opportunities (see Box 7).

Conclusion

During the first years of *perestroika* (1985–89), when the initial positions for economic restructuring — monetary overhang, the government budget deficit, external indebtedness — were not bad at all, the costs of economic reforms could have been paid by increasing imports of consumer goods and financing them through normal commercial borrowing in international financial markets with the Soviet Union's gold reserves as collateral. No assistance from abroad would have been needed, and the loans could have been paid back in five to seven years, after *perestroika* began to pay for itself. Unfortunately, this opportunity was missed; the Soviet government failed to implement radical market-type reforms and borrowed abroad just to meet its current balance-of-payments requirements. As a result, the position for economic reforms deteriorated and foreign indebtedness increased. By 1989, it was no longer possible to pay the costs of restructuring by normal borrowing, without any Western assistance.

Another chance to ensure a smooth transition to a market economy was missed in 1990, when the Soviet government failed to approve Shatalin's program and to ask for Western assistance. It may be argued that if Western governments and international organizations had put together an assistance package and offered it to the Soviet Union in ex-

Box 8: *The Case for Western Assistance — With Conditions*

For the West, the single most important channel of influencing the course of events in the Soviet Union is still the conditional assistance package. By leaving the door open for negotiations about such a package, the West could increase its opportunities for encouraging democratic and market-oriented reforms in the USSR.

It is reasonable, therefore, for the West to consider putting together a "perestroika assistance package", and announcing that it would be available to the Soviet Union if it met various political and economic conditions:

- No human rights violations.
- Commitment of the government and the parliament to radical market-type reforms.
- Agreement between the republics and the central government on the distribution of economic powers and on economic and monetary union.

It is quite likely that this kind of proposal, worked out jointly by the major Western countries, the European Community, the International Monetary Fund, the World Bank, and the European Bank for Reconstruction and Development, would lead to a national debate in the Soviet Union that would stimulate democratic and market-oriented reforms.

change for a commitment to a radical market-type reform, it could have become a major factor in Soviet internal politics, leaving far fewer chances for the conservative restoration that has occurred in recent months. Yet the conservative developments in Soviet politics do not mean that all Western assistance to the USSR should be canceled or that the case for providing new aid should not be considered (see Box 8). After five years of *perestroika*, the opportunities for the painless restructuring of Soviet economy have been lost once and for all. Soviet citizens, who have already experienced a slow erosion of their living standards, are now facing an inevitable, considerable reduction of real incomes, a slump in output, and a soaring unemployment rate that may reach as high as 15–20 percent. Regions of depression may emerge, most likely in areas where heavy industry dominates, such as the Donbass coal mining region in southern Ukraine, the Urals, and Leningrad.

Various scenarios for market-type reforms still exist, although none of them ensures a low-cost transition to a market economy.

The most important questions now are: How much and for how long will people have to tighten their belts? In what way will the costs of *perestroika* be distributed among various social groups, republics, and regions? Will people be willing to accept these sacrifices without strikes and unrest?

For the next year or two, the highest national priority will be to survive economic difficulties without social and national unrest. The Soviet people must get used to the idea that the blow can be attenuated but not dodged. The income cuts *must* be shared fairly by various social and ethnic groups, by individual republics and regions, and by enterprises. Losses are much harder to share than profits; when material difficulties increase, people are apt to show their worst qualities. Can the USSR avoid an excess escalation of social demands, increases in the number of strikes that further reduce real incomes, and other developments that could turn the entire process into a chain reaction? Can all the people — radicals and conservatives, Jews and Russians, members of cooperatives and trade unionists — agree in a civilized manner on how to share the burden of restructuring costs?

I want to believe that we Soviets will exercise enough self-control to pass the now-inescapable time of economic hardship without panic or violence. Life goes on, and so does *perestroika*. Unless we tighten our belts, we will fail to establish an efficient market economy. In the past, things were sometimes even worse, so let us be patient in riding out the trials we now face and do our best to hasten our movement to a full-fledged market economy, to which there is no alternative anyway.

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